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Carol X Weakley 10/27/2006 12:22:41 PM From DB/Inbox: Carol X Weakley

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Text:

C O N F I D E N T I A L TEL AVIV 04269

SIPDIS  
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ACTION: ECON  
INFO: IPSC SCI IMO CONS RES POL DCM AMB PD AID ADM  
FCS

DISSEMINATION: ECON  
CHARGE: PROG

APPROVED: AMB:RHJONES  
DRAFTED: ECON:JNWITOW,EWESTRU  
CLEARED: DCM:GCRETZ, ECON:WWEINSTEIN, POL:PVROOMAN

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TO RUEHC/SECSTATE WASHDC IMMEDIATE 7215  
INFO RUEHXX/ARAB ISRAELI COLLECTIVE IMMEDIATE  
RHEHNSC/NSC WASHDC IMMEDIATE  
RUEATRS/DEPT OF TREASURY WASHDC IMMEDIATE

C O N F I D E N T I A L SECTION 01 OF 03 TEL AVIV 004269

SIPDIS

NEA/FO FOR DANIN; NEA/IPA FOR WILLIAMS, SHAMPAINE,  
BELGRADE; EB/FO FOR DIBBLE; EB/OMA FOR GARRY; NSC FOR  
ABRAMS, WATERS; TREASURY FOR HIRSON

E.O. 12958: DECL: 10/25/2016  
TAGS: [ECON](#) [EFIN](#) [PGOV](#) [PREL](#) [SCRM](#) [IS](#) [KPAL](#) [KWBG](#)  
SUBJECT: BOI GOVERNOR SEES EXCELLENT ISRAELI ECONOMIC  
PERFORMANCE DESPITE WAR

Classified By: Ambassador Richard H. Jones for reasons 1.4 b and d.

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Summary  
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1. (C) Governor of the Bank of Israel (BOI) Stanley Fischer told the Ambassador that Israel's economic situation is excellent, despite the recent war, which slowed 2006 economic growth by about one percent. Inflation is very low, and the .25 percent interest rate decrease on October 23 was meant to bring it up into the one to three percent target range. The 2006 deficit should be about 2.5 percent of GDP and growth is forecast to be in the four percent range. Fischer said that fiscal policy is tighter than it appears, given that the Ministry of Finance (MOF) always understates revenues to help keep expenditures under control, and added that the results of the defense spending review currently underway will have a great impact on budgeting decisions in the next few years. He indicated that, as far as he knew, MOF DG Yossi Bachar was leaving his post for purely personal reasons. On the establishment of the new Economic Advisory Council (EAC) in the Prime Minister's office, Fischer expressed great enthusiasm and strongly praised its Director, Manuel Trajtenberg. On the proposed BOI Law, Fischer expressed great frustration at the impasse over the workers' wage demands, and said that the MOF's unwillingness to help solve the problem called into question the underlying assumption that guided the formulation of the law that an atmosphere of goodwill and cooperation would always prevail between the MOF and the BOI. Regarding the Israeli-Palestinian correspondent

banking situation, Fischer said that a solution is at hand. (Note: the agreement was approved on October 25 by the Knesset Law and Justice Committee, but is still subject to further deliberation. End Note). End Summary.

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Overall Economic Picture Excellent  
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12. (C) In an October 24 meeting at the BOI, Fischer told the Ambassador that the overall Israeli post-war macroeconomic picture is surprisingly good. The war caused about a one percent decline in annual GDP growth numbers with the worst damage being in the third quarter when the Bank expects the numbers to show a slight contraction in GDP. The post-war recovery was very fast, with exports undamaged and domestic consumption picking up quickly. While there was some short-term contraction in industrial production in the northern part of the country, it is the tourism sector that will suffer longer-lasting damage. The housing sector was not much affected by the war, but is recovering surprisingly slowly from the deep recession earlier in the decade.

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Defense Spending the Wild Card  
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13. (C) Fischer forecasted that the government will end the year with a budget deficit of 2.5 percent of GDP. The deficit is expected to increase next year, but it should still come in under the three percent target. The big unknown for next year will be the result of the defense spending review. Fischer is surprised at how many people think the MOD can get by with a smaller budget, even after all of the post-war talk of the need to increase defense spending. He is of the mind that if you want more of something, you generally need to pay more for it, but lots of people who claim to be knowledgeable on defense issues tell him that there's a fair amount of waste and inefficiency that can be cut.

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Fiscal Policy Tighter Than it Appears  
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14. (C) Fischer thinks fiscal policy will turn out to be tighter this year than the numbers seem to indicate right now, since the boys in the Treasury like to underestimate revenues to help keep expenditures under control. He is "amazed" at how much the targets (set in the 2003 U.S.-Israel Loan Guarantee Agreement) do to help keep ministers, spending demands in check. Although a lower deficit would be desirable, the MOF is confident the debt-to-GDP ratio will continue to fall next year due to revenues generated by the continued privatization of government-owned industries, such as the Haifa Oil Refineries company. The BOI forecast four percent GDP growth in 2007, taking into account the possibility of governmental instability. Noting, however, that the coalition has been "bought relatively cheaply" and did not bust the budget, Fischer added that the government now appears to be relatively stable. Therefore, next year is likely to be considerably better, barring a global recession or a deterioration in the security situation.

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Inflation Too Low  
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15. (C) Calling it "embarrassing," Fischer said that Israel will end the year with inflation below the one to three percent target range due to the currency's appreciation and falling oil prices. The Bank debated cutting the rate by more than the .25 percent (down to 5.25 percent) announced on October 23, but they decided against it because things can change so quickly in Israel. Bigger cuts have been made in the past, "but they have always failed."

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## Bachar Leaving MOF For Personal Reasons

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16. (C) Responding to the Ambassador's query regarding the impact of the departure of Ministry of Finance (MOF) Director General Yossi Bachar, Fischer did not have much to say. He noted only that Bachar's job is &very wearying,8 and thinks he is leaving simply because he is tired and wants to move on to something else. He added that Bachar personally told him that there is no truth whatsoever to the rumors and press reports that he "doesn,t like Hirschson." Fischer then stressed the need to "have someone good in that position" and said that there are a lot of talented candidates.

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## Positive on New Economic Advisory Council

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17. (C) When the Ambassador raised the issue of Olmert,s new Economic Advisory Council (EAC), Fischer called it a "good thing" and said that its chief, Manuel Trajtenberg, is a very good pick -- a "great researcher" who was mentored by a good friend of his. He said that the BOI will work well with the EAC. Some of his BOI colleagues initially were worried that the EAC would infringe on the Governor,s designation as the "Economic Advisor to the Government," but since the BOI doesn,t design its research program based on the Prime Minister,s objectives, the PM needs his own economic advisor to work on his priorities. If Olmert doesn,t have &his own guys,8 the &boys at the Treasury8 will rule. As an example, he said that MOF footdragging has prevented Olmert from introducing a negative income tax, an idea he has championed since his tenure as Finance Minister. The MOF bureaucracy continually came up with reasons why it would be a bad idea despite the minister's expressed desire to make it happen.

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## BOI - MOF Relations At Low Point

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18. (C) Regarding the status of the BOI law, Fischer said that "nothing is happening with it now." The negotiations are stuck on the issue of wage arrangements for BOI workers, and will soon reach a crisis point. The MOF won,t move on a wage agreement, and the workers won,t allow the law to proceed without it. The problem is that the MOF does not want to accept responsibility for a wage agreement that would result in a large payout to retirees at a time of supposed fiscal austerity. In the end, the retirees will receive some of the money they had originally been promised, but the MOF's fear of investigations by the press, the State Comptroller, the Movement for Quality Government, etc. means that reaching an agreement will require the intervention of the PM. The MOF,s attitude towards this dispute is causing Fischer to reevaluate some elements of the proposed BOI law, which are based on a presumption of goodwill between the BOI and the MOF. He no longer is sure if that can be counted on; &If they want to pull my tail on the wages, they can,8 he said. Regarding the recent State Comptroller investigation into alleged wage improprieties (which involves some current employees), he characterized it as &sheer harassment8 and is sure the Comptroller will lose the case. On a positive note, Fischer noted that GOI officials -- including those from the MOF -- never exert any pressure on interest rate decisions and he is given a free hand to control the Bank,s policy decisions -- the "things that matter."

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## Israeli-Palestinian Banking Solution At Hand

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19. (C) In response to the Ambassador's question on the status of the Israeli-Palestinian correspondent banking issue, Fischer said he thinks it has been resolved, but will require some months to implement, even after Knesset approval. (Note: The Knesset Law and Justice Committee approved the agreement on October 25, but it is still subject

to further deliberations. End Note). The holdup was that the anti-terror finance people in the Justice Ministry originally wanted to require that every single check written from a Palestinian bank be cleared against a watchlist, as opposed to the requirement in the agreement that only checks written for amounts greater than NIS 5000 be subjected to such scrutiny. Implementing this demand would have doubled the number of checks scrutinized from 880,000 per year to about 1.9 million. Fischer called this "untenable" and said the banks simply would not do it. He noted that he talks frequently with George El-Abed, the Palestinian Monetary Authority Governor, and that the Palestinians have been very cooperative in already taking some tough measures to begin implementing the agreement. He added that the banks (Israel Discount Bank and Hapoalim) will threaten to cut off the services fairly frequently, but that the GOI has given them the assurances and procedures they need to keep clearing checks. On the whole, IDB has been more cooperative than Hapoalim, but Hapoalim always comes around in the end. Fischer also said that the Israeli banks have asked him about the U.S. attitude towards the situation. After speaking to U.S. Treasury officials, he said that he was able to assure the banks that the U.S. is unlikely to prosecute banks who have made a good faith effort to thwart terror financing. However, the USG could "obviously" not guarantee that a bank would not be subject to laws that are on the books.

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JONES